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SUBJECT: German Banks: Light at the End of the Tunnel?

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11. (SBU) Summary: Summary: The first half of 2003 witnessed stabilization in the German banking sector after a disastrous 2002 - the worst since the war. However, German banks are not out of the woods yet. Continuing benefits of cost cutting, consolidation, cooperation on back office operations and securitization and promise of an economic recovery would all be for the good. Despite these bad times for some German banks, Germany is a place where bankers can make money. Buying distressed loans or selling good ones through securitization means business. Some investment banks are ramping up their German operations, a sharp contrast to the reduction in activity of many German banks - an indication that the landscape of German finance is changing. End summary.

2002: Banks Hit Rock Bottom?

12. (SBU) In its September monthly report, the Bundesbank carries an article on the earnings situation of German banks in 2002, which was even worse than the year before. All banks' operating profits taken together amounted to 6.8 billion euro, after 13.4 billion euro in 2001. Total annual net profits fell from 14.5 billion euro in 2001 to 10.6 billion euro in 2002. Risk provisions were the most important factor negatively affecting banks' revenues. These resulted mostly from domestic loan business due to a significant increase in insolvencies. Commission revenues went down because of low turnover at the exchanges and very few IPOs. Net interest revenues were a positive factor, largely due to low-interest sight deposits. Net extraordinary revenues also increased, as a result of write-ups in the banks' own investment portfolios.

Competitors Exaggerating Crisis?

13. (SBU) However, the situation is probably not as bad as some would like to make it out to be. A recent article in the Financial Times reported that the Financial Supervisory Authority (BaFin) participated in supervisory board meetings of at least the top ten German banks. The article suggested that this was a sign of the desperate situation in the German banking sector. However, the Federal Association of German Banks stated that supervisors' participation in supervisory board meetings are "an absolutely normal procedure" and by no means crisis management. A BdB spokesman called the FT's conclusions incomprehensible, saying that this looked like cheap propaganda against Germany as a financial center even though the FT knows better.

German Bankers Face Structural Disadvantages

14. (SBU) A study by Boston Consulting Group (BCG), which focused on retail business, found that it is not so much poor business models or bad management that are responsible for German banks' low profits. Instead, structural differences in the banking markets explain 70% of the difference in profits between German banks and their competitors in the EU. There are three factors that put German banks at a disadvantage: the interest margin is very low in Germany due to strong competition, labor costs are high, and households' financial assets are lower than e.g. in Great Britain.
15. (SBU) Of course, nobody doubts that German bank managers have also made mistakes, adding to the difficult environment. However, the BCG study may provide an explanation why the large German banks have so far not been taken over despite their low market capitalization - i.e. any new owners would have to cope with the same problems.

Nonetheless, some foreign banks, such as Citigroup and ING subsidiary Diba, prove that it is possible to be successful in the German market. Diba is currently about to overtake Commerzbank with regard to the number of retail customers.

Effects of Restructuring Efforts Beginning to Show

16. (SBU) The good news is that the German banks recognized their problems and managed to cut costs considerably. Overall, in 2002 they reduced administrative costs by almost 4% compared with 2001, half of which in personnel costs and half in other areas. The large private banks were particularly successful with administrative costs going down by 11.2%. The German banking sector overall cut 18,300 jobs, so that the number of employees dropped below the level of 1992. Private banks alone reduced their staff by 12,000, but also the savings banks cut 4,000 jobs. Reductions in the number of branches also played an important role: overall it decreased from 37,585 in 2001 to 35,340 in 2002. In the course of last year, the savings banks closed down almost 1,000 branches, the cooperative banks over 700 and the large private banks more than 100.

17. (SBU) The Bundesbank believes that banks' profits reached a low in 2002, and that 2003 will be better. Stabilization of the economy should contribute to this. In particular, asset valuation expenses (i.e. marking assets to their market value) are expected to go down considerably this year. Moreover, the upswing in the stock markets should have a positive effect on revenues. The Bundesbank also argues that the effects of the 2002 cost cutting programs have not yet fully shown so that costs can be expected to fall further this year.

18. (SBU) The first positive results of restructuring could already be seen in the first half of 2003. Deutsche Bank fared best among large German banks. In the first half of 2003, it made a profit before tax of 1,325 million euro and of 353million euro after tax, mainly benefiting from investment banking and business with corporate clients. In the first half of 2003, Dresdner Bank actually made a loss before taxes of 450 million euro, which, thanks to a tax refund, turned into a profit of 25 million euro after tax. Over that period, Dresdner made an operating profit of 7 million euro, compared with a loss of 873 million euro in the first six months of 2002. Commerzbank showed with its result for the first half of 2003 that the worst seems to be over. Its consolidated profit amounted to 73 million euro. CEO Klaus-Peter Miller stated that he expects his bank to make a positive operating profit for the year 2003 as a whole. In the first six months of 2003, Hypo-Vereinsbank made an operational profit of 238 million euro, after an operational loss of 413 million euro in the first half of 2002. It made an overall profit of 144 million euro during that period

19. (SBU) In particular, massive job cuts have helped to bring down costs, with more likely to come. Banks focused on their "core business," and outsourced or closed down entire business segments. The securitization of "good" loans was another helpful strategy. Increasing bond issue business has had a positive effect on profits so far. The private banks are now focusing more on retail customers, a less cyclical business segment so far left to savings and cooperative banks. A Bundesbank contact we spoke with identified cooperation in back office operations, e.g. securities settlement as well as large-scale securitization via a "true sale" of the assets organized by KfW, as another new trend in the sector and expects it to increase efficiency. On October 1, Deutsche and Dresdner announced that their payments will be settled by Postbank.

110. (SBU) The sell-off of "bad" loans will likely pick up in the course of this year. Experts expect that trading in such "bad" loans has an enormous potential. According to Aidan Freyne, Director for distressed debt at Citigroup "all important competitors want to be present in Germany." Mattias Mosler, head of Merrill Lynch in Germany, stated that Germany is becoming the most important market for such business in Europe. Merrill is opening up an office to deal with such loans in Germany. More generally, Mosler believes that Germany is key for investment banking in Europe. "Only those successful here can play a major role in the other European countries, too." Merrill Lynch currently has 220 employees in Germany and plans to hire more.

Looking ahead

111. (SBU) The mood in the German banking sectors is clearly brightening up. After a phase almost exclusively focused on

cost cutting, the banks are now starting to develop visions and strategies for the future.

¶12. (SBU) Deutsche Bank's CEO Josef Ackermann stated that "we want to be leading at the global level and, at least in our core business areas, to count among the five best worldwide". Deutsche Bank is also watching out for potential takeover targets, particularly in the business segment "high net-worth clients". Ackermann also announced that Deutsche Bank will try to sell many of its equity holdings. Hypo-Vereinsbank (HVB) aims at increasing its market share in Northern Germany, with the upcoming integration of the Hamburg-based Vereins- und Westbank. At the same time, HVB also plans further acquisitions in Eastern Europe. Moreover, HVB wants to focus more on certain activities, e.g. in retail banking it will concentrate on marketing, while production will likely be outsourced. Commerzbank CEO Klaus-Peter Mller stated that his bank plans to grow in the asset management and retail business, which could also involve acquisitions. The bank also wants to focus its corporate clients business more on SMEs, aiming at 9,000 new SME customers in the next three years. This business segment is to be linked more closely to investment banking.

¶13. (SBU) Looking further ahead, there is a hot debate on the process of consolidation of the banking sector. In its Financial Sector Policy Assessment, the IMF suggests that consolidation should be permitted across the three "pillars" of German banking, e.g. the private, state, and savings/cooperative banks. This has provoked a sharp negative response from the savings and cooperative banks but was welcomed by private banks. Bundesbank senior banking officials have taken the view that the three pillars should be preserved as they have been a successful model for Germany in the past. Others in the Bundesbank take a more nuanced view, namely that the elimination of state subsidies in 2005 will force the state and savings banks to adopt new models, including, eventually, injections of share capital. They would become private in all but name. The Finance Ministry also sees market forces playing a hand at reshaping the sector over the longer term but, for the moment, does not wish to invite the ire of the savings banks.

Not yet safe

¶14. (SBU) Even though the situation of German banks is stabilizing, Rolf Breuer, President of the Federal Association of German Banks (BdB) and chairman of Deutsche Bank's supervisory board, stated that "there is no reason for premature optimism. The level that we will reach this year is still extremely low." Bundesbank Board Member Edgar Meister believes that the restructuring measures currently undertaken by the German banks will strengthen them. He argues that "the sustainability of the German banks' recovery is also dependent on economic recovery. Our Bundesbank contact stated that it is still "not time for euphoria". She described the current situation as "stabilization with an upward outlook". She also pointed out that while cost cutting is indeed necessary, there is also a risk that banks cut them so much that they destroy their own income base. Standard & Poor's also believes that vulnerability still exists in the German banking sector.

¶15. (SBU) While stock prices of the large German banks went up in the first half of 2003, this trend now seems to have come to a halt. During the first six months of the year, German banks benefited from high interest revenues and low risk provisions in the loan business. According to some analysts who claim that in a weak economic environment banks usually have to increase risk provisions towards the end of the year, the second half of the year will be more difficult. Given the bleak economic outlook for Germany, the number of loan defaults might increase. Moreover, at the beginning of the year banks had unexpectedly high revenues from bond trading which are unlikely to continue as bond returns increase. The large German banks' return on equity remains low by European standards. In the first half year, it was 2.4% after taxes for Deutsche Bank, and even negative for Hypo-Vereinsbank. In contrast, JP Morgan Chase, Credit Suisse or UBS reach an equity return of more than 17%.

¶16. (SBU) In addition, the market capitalization of German banks, once among the top international banks, is very low by international comparison. For instance the current value of HSBC is at 126.6 billion euro, and that of the Royal Bank of Scotland at 68.3 billion euro, while the market capitalization of Deutsche Bank amounts to 31.5 billion euro, that of Hypo-Vereinsbank to 8 billion euro and that of Commerzbank to 7.3 billion euro. For many observers, Deutsche Bank is the only one of the large four German banks

that can lay claim to a global role. How times have changed.

17. (U) This cable was coordinated with Embassy Berlin.

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